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No. 81-2394

In The

Supreme Court of the United States

October Term, 1983

WESTINGHOUSE ELECTRIC CORPORATION,
Appellant,

—against—

JAMES H. TULLY, JR., *et al.*,
AS THE TAX COMMISSION OF THE STATE OF NEW YORK,
Appellees.

ON APPEAL FROM THE COURT OF APPEALS OF THE STATE OF NEW YORK

REPLY BRIEF OF APPELLANT

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Appellees' basic argument appears to be simple. Appellees admit that New York is attempting to tax income earned from transactions in which exports are "shipped from a regular place of business . . . within" New York, N.Y. Tax Law §210.13(a)(2), at a lower rate than income earned from exports shipped from outside the state. (Appellees' Brief at 15, 21.) They claim, however, that this discrimination is constitutionally permissible because the differential tax rate is applied only to New York's apportioned share of the combined net income of appellant Westinghouse Electric Corp. ("Westinghouse") and its wholly owned DISC subsidiary, Westinghouse Electric Export Corporation ("Westinghouse Export" or "Export").

Appellees' reliance on the distinction between apportioned and unapportioned taxes is misplaced. Whether a discriminatory tax rate applies to all of a taxpayer's net income or only to an allocated portion of it makes no constitutional difference. The fact is that the amount of tax paid with respect to income from particular transactions will be lower if the transactions occur in-state than if they occur out-of-state. Such a differential tax rate depending on the location of business activity is precisely the kind of taxing scheme struck down by this Court in *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977).

Assume that a corporation has all of its payroll, property and revenue located in New York apart from a permanent shipping facility of insignificant size located in New Jersey. A very large part of that corporation's income would be taxable in New York. When confronted with the decision whether to ship its export products from New Jersey or New York, that corporation would be confronted with the fact that DISC income derived from a New Jersey shipment would bear tax at a rate of 9%, while income derived from a New York shipment would be taxed at 2.7%. It is that undeniably discriminatory effect which invalidates New York's tax. And that discriminatory effect exists whether New York, because of the geographical dispersion of a taxpayer's business, taxes 5% or 100% of its income.

As a matter of mathematical logic, appellees' position makes no sense. When an allocation percentage, say 5%, is applied to a net income figure, the mathematical effect is that 5% of every item of income of the taxpayer is taken and totaled together. Use of an allocation percentage is merely a way of approximating what amount of a corporation's total income is attributable to its activities in a particular state. This method is used as a convenient substitute for accounting for the state-by-state origin of each dollar of a multi-state corporation's net income. But it necessarily means that, contrary to appellees' position, the amount of money which New York taxes after the allocation formula is applied is derived in identical fractions from each item of income of Westinghouse and Export. Thus,

New York's 5% allocated share of Westinghouse's income necessarily includes 5% of Westinghouse's income from its New York operations, 5% of Westinghouse's income from out-of-state operations, 5% of Export's income from export shipments made from within New York, and 5% of Export's income from export shipments made from outside New York. Appellees are therefore simply wrong when they say that New York "never taxed in the first instance" any out-of-state income. (Appellees' Brief at 19.) Income from out-of-state sales is being taxed, and when such income is accumulated DISC income, it is being taxed at more than three times the rate of in-state accumulated DISC income. (*See* Appellant's Brief at 17.)

The fallacy in appellees' position is highlighted by their claim that New York's limitation on the export credit does "not affect interstate commerce in any greater degree than any other state tax or credit on business income." (Appellees' Brief at 19.) In fact, other typical kinds of credits based on in-state activity, such as those noted by California in its brief (Amicus Brief at 2), are granted in a manner that is distinguishable from New York's export credit. These credits are different from New York's because they are calculated solely on the basis of investments or expenditures made by the taxpayer within the taxing state. For example, an investment of $1 million in a new plant in a state might entitle a taxpayer to an investment tax credit of 10% or $100,000 against the franchise tax otherwise payable. The direct effect of such a credit is to reduce the effective cost to the taxpayer of making a particular expenditure. A credit that is measured by the amount of in-state investment or expenditure thus rewards in-state activity, but it does not at the same time inflict a penalty if the taxpayer chooses to make such investments elsewhere. On the other hand, use of a ratio such as New York's comparison in this case of the gross amount of in-state export shipments to out-of-state export shipments is unconstitutional because its effect is to punish the taxpayer for having engaged in business activity outside the state. The amount of the credit decreases as out-of-state activity increases relative to New York activity; the

taxpayer is penalized by increased New York taxes for every shipment that it makes from out-of-state.[1]

Nor can appellees' claim that New York is merely giving up part of the tax payable on income that the State is constitutionally permitted to tax at whatever rate it chooses withstand analysis. While it is true that the Constitution may not require New York to give any tax credit on accumulated DISC income, and that, more generally, New York may impose a franchise tax at any rate it chooses, once the State has determined to grant a credit, the credit itself must be computed in a constitutionally allowable manner. To use a hypothetical example, there can be no doubt that a tax credit which depended upon the race or national origin of a corporate taxpayer's stockholders would be unconstitutional. The constitutional equation would not be altered by the fact that the state was taxing only a properly apportioned share of the corporation's income. When the state determines how to tax its apportioned share, relief from the tax so imposed must be granted in a constitutionally proper manner. Just as discrimination in the tax rate on the basis of race would be unconstitutional, so, under *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318 (1977) and *Maryland v. Louisiana*,

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[1] For example, assume that a taxpayer which is a combined parent-DISC entity has gross receipts of $1,000 from the shipment of export property from a regular place of business in New York and gross receipts of $1,000 from export shipments from a regular place of business in California. Assume further that the income derived from that $2,000 in export shipments is $200 and that the taxpayer's New York allocation percentage is 50%. In that case, New York could tax $100 of the taxpayer's export income. The DISC export credit would be calculated by taking the taxpayer's accumulated DISC income, which can be no more than half of total export income, 26 U.S.C. § 995, or $100, and multiplying that amount, first by the proportion of New York export shipments to all shipments (50%), and then by New York's allocation percentage (also 50%). *See* N.Y. Tax Law §210.13(a). The product, $100 x 50% x 50% = $25, is the amount eligible for the DISC export credit. That amount is then multiplied by 70% and by the tax rate (9% for the years in question) to ascertain the amount of the credit: $25 x 70% x 9% = $1.575. The net tax bill

451 U.S. 725 (1981), discrimination against business operations conducted in other states is forbidden as well.[2]

Both appellees and amicus, the State of California, argue that *Boston Stock Exchange* and *Maryland v. Louisiana* are distinguishable because neither case involved an apportioned tax. That distinction is irrelevant. In both cases, there was no question that the state had the constitutional power to impose some tax because a taxable incident had occurred within the state's borders. Similarly here, there is no doubt that New York may impose a tax on the net income of corporations which do business in the State. An apportionment formula is merely

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would then be $100 of export income allocable to New York multiplied by the 9% tax rate, or $9.00, less the credit of $1.575, or $7.43.

Now assume that the same taxpayer decides to double its California export operations while maintaining precisely the same export operations in New York, and assume that the new California operations generate profit at the same rate as the old, but will require increased property and payroll in that state such that New York's allocation percentage drops to 33⅓%. Thus, the taxpayer will have total export receipts of $3,000 and export income of $300. Of this $300 in export income, New York's dollar share remains at $100—as it logically should since the taxpayer's New York operations are unchanged in amount—and the tax payable before operation of the credit remains $9.00. However, the credit will be smaller: The taxpayer now has $150 in accumulated DISC income which is multiplied by New York's share of export shipments (now 33⅓%) and by New York's allocation percentage (also 33⅓%), giving $150 x 33⅓% x 33⅓% = $16.67, and resulting in a credit of $1.05 ($16.67 x 70% x 9% = $1.05). Thus, the net tax increases from $7.43 to $7.95 solely because the taxpayer chose to increase its California export operations.

[2] The constitutional problem is exacerbated when a state seeks to impose a tax on a unitary combined return basis on affiliated corporations such as Westinghouse and Export. In the case of such a tax, not only "[t]he corporate boundaries are ignored" (Amicus Brief at 3), but state boundaries are also ignored in computing the total income to be reached on a unitary basis. Yet in granting a credit such as New York's in this case, corporate boundaries are carefully observed by limiting the credit to shipments from a regular place of business of the taxpayer (*i.e.*, Westinghouse, and not Westinghouse's non-New York affiliates) and state boundaries become crucial as well, since the taxpayer's regular place of shipment must be located in New York to qualify for the credit.

another way in which New York imposes its taxes on multi-state enterprises under the limitations of the Due Process and Commerce Clauses. By no means, however, does the use of a proper apportionment formula immunize all aspects of the tax from scrutiny.

Put another way, the business activities which the states sought to tax in *Boston Stock Exchange* and *Maryland v. Louisiana* were activities of which elements took place both in-state and out-of-state. The in-state elements were sufficient to give the state the power to tax the activity. Both taxes were struck down because the amount of tax payable depended on whether particular aspects of the transactions occurred in-state or out-of-state. Similarly here, Westinghouse's export activities (in the aggregate) have both in-state and out-of-state elements and the amount of credit granted on account of such activities depends on the location (in the aggregate) of transactions within or outside of the state.

Appellees also contend that the limitation on the export credit is proper because the state "has simply chosen to tax that part of the taxpayer's New York income stemming from *exports* (New York related exports since only New York income is being taxed) at a lesser rate than *non-export* New York income." (Appellees' Brief at 20; emphasis added.) This contention is erroneous, first, because while only an apportioned share of Westinghouse's income is being taxed, that share does include income from export shipments from outside New York.[3] Second, the export credit does not in fact differentiate between export and non-export income. The amount of the credit is based (as appellees elsewhere acknowledge, Brief at 23) on the ratio of a taxpayer's sales receipts from exports shipped from a regular place of business within New York to the taxpayer's total receipts from exports. The amount of the credit is not—as appellees' argument implies—based on the ratio of Westinghouse Export's income (which is by definition entirely export-related income) to the total income of Westinghouse and Westinghouse Export combined. Such a ratio, based on the type of transaction which generates the income,

[3] *See supra* pp. 2-4.

might be constitutionally allowable. But that is very different from a ratio based on the location of a particular type of transaction.[4]

Appellees make the remarkable argument that the export credit does not "provide a significant inducement to corporations to conduct export businesses . . . in New York." (Appellees' Brief at 21.) Apparently to make the same point, they also present statistics purporting to show that New York's share of the nation's export business has declined since 1972 when special tax treatment of DISCs was initiated. These arguments are irrelevant, for this Court "need not know how unequal [a tax] is before concluding that it unconstitutionally discriminates." *Maryland v. Louisiana*, 451 U.S. at 760. In any

[4] Moreover, appellees' argument implicitly assumes that the method used to calculate the amount of the credit (ratio of shipments from in-state places of business to shipments from out-of-state places of business) properly attributes net income to the State. This assumption is wrong because the place of shipment does not necessarily have any relation to the place in which net income is actually earned.

The "parade of horrors" presented in the California amicus brief (at 11) is based on hypotheticals which are simply not analogous to the tax at issue here. California claims that the logical extension of Westinghouse's argument would be to invalidate state tax laws which impose no tax whatsoever on DISC income. This example only serves to confirm Westinghouse's claims, however, for it assumes that the state is refusing to tax *all* of a taxpayer's DISC income rather than discriminatorily exempting DISC income assumed to be derived from New York shipments. The proper analogy to this case is a tax scheme which imposed no tax only on the apportioned in-state share of a taxpayer's DISC income, but included in taxable income all DISC income attributable to out-of-state sources. Westinghouse's argument would require invalidation only of the second type of tax. For the same reasons, adoption of Westinghouse's position would not make it unconstitutional for a state to abolish its corporate income tax nor would it require states to impose such taxes or to impose them at a uniform rate. Changing the overall rate across the board, or abolishing a tax entirely, is clearly permissible. What is unconstitutional is manipulating the effective tax rate so that in-state business activities result in a lower tax rate than income generated from out-of-state activities.

event, appellees' claims fly in the face of common sense as well as the express findings of the Court of Appeals and the New York Legislature. The legislative history of the credit indicates that it was intended to "provide a positive incentive" and a "tax advantage" "for increased business activity in New York State."[5] The Court of Appeals acknowledged that the purpose of the credit was to provide "State tax incentives" "to ensure that New York would not lose its competitive position vis-a-vis other States". (J.A. 63-64.) These statements, which clearly establish New York's discriminatory purpose, foreclose any justification of the export credit based on an alleged de minimis effect.[6]

Appellees and amicus criticize Westinghouse for arguing (Appellant's Brief at 21-22) that the discriminatory effect in limiting the DISC export credit to New York shipments is exacerbated by the requirement that the income and expenses of a DISC be combined with those of its parent, N.Y. Tax Law §208.9(i)(B), without an adjustment in the apportionment formula to take account of the payroll, property and receipts of Westinghouse's "non-New York affiliates" (*i.e.*, subsidiaries of Westinghouse which admittedly do no business whatever in New York and are not taxed by the State) whose business activities contributed 20-25% of Export's income. Appellees

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[5] New York Division of the Budget, Report on A. 12108-A and S. 10544 (May 23, 1972), *reprinted in* Bill Jacket of 1972 N.Y. Laws, ch. 778, at 13, 18; New York Department of Commerce, Memorandum Recommending Approval of Assembly Bill A. 12108-A (May 24, 1972), *reprinted in* Bill Jacket of 1972 N.Y. Laws, ch. 778, at 9, 11.

[6] Indeed, one provision of the Louisiana First-Use Tax struck down in *Maryland v. Louisiana*, 451 U.S. 725 (1981), was a "Severance Tax Credit." In finding that such credit discriminated against interstate commerce, this Court used language that is equally applicable here in light of the avowed purpose and plain effect of New York's export credit:

> "The obvious economic effect of this Severance Tax Credit is to encourage natural gas owners involved in the production of OCS gas to invest in mineral exploration and development within Louisiana rather than invest in further OCS development or in production in other States."

451 U.S. at 757. Limiting the New York export credit to in-state shipments similarly encourages investment in New York for export shipping facilities at the expense of other states.

themselves, however, place fundamental reliance on the apportionment formula as ensuring that "[o]nly the New York portion of the entire consolidated net income" of Westinghouse and Export is taxed. (Appellees' Brief at 16-17.) They claim that the use of the resulting business allocation percentage in computing the export credit saves the credit from attack. (Appellees' Brief at 26.) But, if the apportionment formula is not in fact fairly applied, the entire premise of appellees' justification for the export credit fails.

The problems that may arise from use of an apportionment formula in the particular context of required combined reporting by a parent corporation and a DISC subsidiary, set up essentially as an accounting convention, cannot be ignored. While there is no difficulty if the only income of such a DISC is derived from transactions with or on behalf of its parent, where—as is admittedly true in this case—the DISC also has income generated from transactions with or on behalf of other affiliates that do no business in the taxing state, apportionment solely on the basis of the property, wages and receipts of the combined parent-DISC entity allows a state to reach out and tax income generated by out-of-state activities of the non-New York affiliates. This income is reached by New York only because it happens to flow through the DISC accounting structure.[7]

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[7] In addition, because the combined reporting requirement is triggered by the fact that the taxpayer "was a stockholder" in the DISC, N.Y. Tax Law §208.9(i)(B), and not by a determination that the entire income of the DISC was earned as part of a unitary business conducted by the taxpayer, it improperly attributes all of Export's income to Westinghouse (by virtue of its 100% stock ownership in Export) when in fact—as is undisputed—only 75 to 80% of Export's income represents value attributable to Westinghouse's activities. The remaining 20 to 25% for the years in question was value attributable to the non-New York affiliates, which appellees concede they have no power to tax.

DISC income differs from ordinary commercial income. DISC income is basically the result of an accounting segregation permitted by the Internal Revenue Code. The property, payroll and receipts which produced the income so segregated with respect to the exports of Westinghouse's non-New York affiliates is that of those non-New York affiliates—property, payroll and receipts which New York improperly ignores by excluding them from the denominator of its apportionment formula.

CONCLUSION

For the foregoing reasons and those stated in the Brief of Appellant, the judgment of the Court of Appeals should be reversed and the case remanded for assessment of Westinghouse's franchise tax liability in conformity with the Commerce Clause of the United States Constitution and the Equal Protection and Due Process Clauses of the Fourteenth Amendment.

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Respectfully submitted,

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